A SPOTLIGHT ON CLIMATE CHANGE

Governance and Sustainability analysts Michelle O'Keeffe and Laura Thomson answer some of the most common climate change questions they are asked in relation to climate change and Baillie Gifford's position regarding it.

IS CARBON FOOTPRINTING USEFUL?

It can be helpful but there are limitations. First, carbon footprinting is backward looking – it tells you nothing about where a company is heading. Second, the underlying data can be subject to a range of calculation approaches, assumptions and exclusions which makes comparability between companies challenging. Finally, when presented in absolute terms it is heavily influenced by the size and profile of the company and/or portfolio, and when presented in normalised terms it can be influenced by other external factors, such as oil price or customer demand.

That said, it can indicate where to focus efforts of carbon-related research and engagement and may help ascertain the direction of travel over time. However, caution is needed: a lower portfolio carbon footprint will not necessarily be supporting the transition to a lower carbon economy.

HOW DOES THE TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (TCFD) DIFFER FROM PREVIOUS DISCLOSURE INITIATIVES?

First, while most of the disclosure requests to date have been backward-looking, TCFD is asking for forward-looking assessment and disclosures. Respondents must predict how they may fare in a +2˚C, +3˚C or +4˚C world. Second, it goes beyond reporting carbon emissions and asks respondents to consider how climate change will affect their operations and market demand for their goods and services, ultimately translating to a financial impact. Third, it engages all parts of the economic system by asking companies, asset managers and asset owners to respond.

TCFD will mean different things for every respondent. Some companies – usually in high carbon-emitting sectors sensitive to changing market and/or operating conditions – will have already developed and have been integrating climate scenario analysis into their risk management processes and strategy for a few years; the changes required to their existing practices may be minimal. For example, mining company BHP Billiton produced their first +2˚C business plan in 2015. For others, including ourselves, this type of assessment will either help to develop existing approaches further, or will be entirely new. As an asset manager, we are convinced that the framework provides opportunities to think differently about our business and the companies in which we invest.

Where many disclosure initiatives have arisen from the third/not-for profit sector, this one has come from the heart of the financial industry, being set up by the Financial Stability Board, supported by the Governor of the Bank of England, Mark Carney, and chaired by Michael Bloomberg, the CEO of Bloomberg and former Mayor of New York. This backing gives it additional credibility and encourages greater participation. The ambition for forward-looking, decision-useful and comparable climate-related financial disclosures can only be welcomed.

HOW MIGHT CLIMATE-RELATED RISKS AND OPPORTUNITIES IMPACT A COMPANY?

Companies and industries do not operate in isolation. Beyond a company's own operations, its supply and value chains – often international and complex – need to be considered. In addition to physical risks, the evolving nature of governments, society and customers can also impact financial performance through reputational damage, decreased consumption habits or loss of a social or regulatory licence to operate.

A luxury goods company may be dependent on an agricultural supply chain for cotton, silk, leather and wool – all raw materials. The quality and consistency of the raw materials will directly impact the quality and value of the final luxury good and is influenced by the environmental growing conditions. It is therefore important for the company to assess, manage and protect the resilience of its supply chain. This will help maintain product quality and competitive advantage. Similarly, an industrial company should seek to understand where it sits within the value chain and work with its suppliers to the benefit of its customers. Products with longer lifespans that are reliable, easily serviceable and energy efficient will support increased customer satisfaction, trust and loyalty.

WHEN THINKING ABOUT CLIMATE RISK, IS 'WHAT' A COMPANY DOES MORE IMPORTANT THAN 'HOW' IT DOES IT?

We believe it's a combination of the two, although tipping the balance in our company-by-company investment analysis would be the 'how'.

On the one hand, a sector with high climate risk exposure isn't entirely made up of high risk companies – take a cement producing company in the construction materials industry as an example. Cement has tangible social benefits: it is a key component for economic development, poverty alleviation, as well as increasing asset lifespans and durability. Nevertheless, the cement industry contributes to around 8% of global carbon dioxide emissions, contributing more carbon dioxide emissions than aviation fuel (2.5%) and only slightly less than agriculture (12%). To meet the Paris Agreement's 2.0˚C goal, this high-emitting industry would need to meet an emissions reduction trajectory of 16% by 2030. In this case, we would be seeking to understand:

– how efficiently an individual company is operating,

– what its emissions performance trajectory is,

– how it approaches environmental risk assessment and management,

– what its supply chain transparency and engagement look like and

– how is it investing in, and planning for, a range of possible future scenarios through lower carbon product research and development.

On the other hand, a sector with low climate risk exposure isn't entirely made up of low risk companies. Take a software company in the information technology (IT) sector as an example. Companies in the software industry may largely be asset-light, intellectual capital organisations, but they rely heavily on traditionally carbon-intensive data centres which account for around 1% of global energy demand. When considered in the interconnected context of the IT sector as a whole – which includes mobile phone networks and other personal communications devices – its contribution to global emissions is more than 2%, bringing it more in line with the aviation industry's emissions contribution from fuel emissions. With data prevalence predicted to increase over the next decades, in this example we would be seeking to understand how the company is managing current and future regulatory risks, the operational efficiency of the data centres and what electricity sources the data centres are/could be powered by.

WHERE DOES THE SOLUTION TO CLIMATE CHANGE COME FROM? IS IT GOVERNMENTS, BUSINESSES OR INDIVIDUALS WHO WILL LEAD THE CHARGE?

Given the scale of the challenge, regulation will undoubtedly be needed to facilitate the required breadth and depth of change. However, while regulation may set the framework, formalise and equalise the incentives, the innovation needed to address the challenge is most likely to come from, as we are already seeing, business and civil society. Many companies have been very vocal about a global carbon price and were active in Paris 2015 at the COP 21 Climate Change negotiations. They recognise where we need to go and are encouraging governments globally to set a level playing field upon which they can compete in providing solutions.

Climate change is often discussed in the context of the type of world we want to leave to future generations. In 2019 change is in the air as civil engagement continues to grow. Around the world, schoolchildren are striking for climate action and 16-year-old Greta Thunberg has been nominated for the Nobel Peace Prize following her special address to global leaders at the 2019 Swiss World Economic Forum.

WHAT SHOULD ASSET MANAGERS BE DOING ABOUT CLIMATE CHANGE?

Climate change and regulatory pressures on carbon emissions are long-term considerations. As investors we have a role to play in supporting companies with their long-term thinking. Where required, we should encourage due consideration of these issues through our engagement and voting activities. Our role is to ask questions and help companies prioritise long-term vision over short-term gain.

Through participation in TCFD, asset managers can encourage greater transparency and information sharing across the entire system, from companies to asset managers to asset owners. This will ultimately drive not just better measurement, but better management, and deliver on the exceptional opportunities that the transition to a low carbon economy provides.

HOW IS BAILLIE GIFFORD SUPPORTING THE TRANSITION TO A LOWER CARBON ECONOMY?

Carbon emissions and climate change are an important part of our investment analysis from a corporate risk and opportunity perspective. Decisions based on such analysis are strategically devolved to our investment portfolios, which seek to understand how specific companies are responding to potentially material challenges. Such analysis will be presented within the company's unique combination of sector, geography, operations and value chain, and not overlooking the timing of the investment case. Of course, climate change often only represents one piece of a jigsaw in the investment process.

Our long-term growth focus means that the transition to a low carbon economy provides us with lots of opportunities. Companies that will be able to prosper over our 5 to 10-year investment horizon will be those that are able to be part of this transition, who are able to offer society solutions to the challenge of climate change and who are able to deliver a strong competitive advantage in a carbon-constrained world. These might include those developing: renewable energy; efficient lighting; electric cars, batteries, and their components; technological solutions; as well as those that are investing in their own production processes to improve their carbon efficiency.

We actively favour innovation, resilience, adaptability and competitive position in the companies in which we invest. Stranded assets, inefficient operations, reputational damage and increasing operational costs are unlikely to feature in our assessment of a prosperous businesses, nor would they deliver sustainable returns to our clients over the long term.

Additionally, through investment strategies that deliver positive outcomes alongside investment returns, we can provide a scale and access to listed equity impact investing to allow clients to allocate capital to companies that are part of finding the solution, rather than being impartial or potential perpetrators of the problem.

IS BAILLIE GIFFORD FOSSIL FREE?

While it would be relatively easy to develop a firm-wide statement on divesting from all fossil fuel related companies, in practice doing this meaningfully has its challenges:

First, where do you draw the line – fossil fuel extractives companies? refineries? heavy fossil fuel users such as cement makers and electricity generators? airlines? shipping? chemicals and plastic producers? combustion engine car manufacturers? Asset owner finance teams will worry about the rapidly narrowing investment universe, their lawyers will worry about overstepping fiduciary duty, and campaigners may never be satisfied that they have gone far enough.

Second, you can take the view that by divesting you are not able to directly influence change – for example through engagement and voting – nor would you be necessarily upweighting stocks that are leading the way on mitigating climate change.

Third, a transition is underway, and it will take time. To effect change at the scale needed we should support companies that are part of that transition no matter what their industry. For example, Danish energy company Ørsted has clear plans to transition all its energy business to renewables and is currently Europe's largest provider of offshore wind power, yet today it still operates some coal-fired power stations.

Finally, the reality is that our economy still needs fossil fuels, particularly gas, as it makes the transition. The key is to understand which players will have a role and which will be left behind, and this cannot be made at an industry level.

Nonetheless, as discussed above, all our investment strategies are aware and are thinking about the possible impacts of climate change on portfolio holdings. The subject area is complex and nuanced, and every company should be analysed and considered on its own merits. Our work continues.

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